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Braced for turbulence

Three European infrastructure managers tell Amy Carroll and Kalliope Gourntis they are confident the asset class will continue to thrive even as the region's economy crumbles

There's no doubt about it – the macroeconomic outlook is miserable, and Europe is being hit the hardest. According to S&P, the UK is already in the throes of a full-year recession. Fitch, meanwhile, predicts that the continent will start to slide backwards in the fourth quarter, with Germany and Italy particularly exposed due to the former's large industrial base and the latter's heavy reliance on natural gas.

Sarah Cole, managing director of investor relations at Igneo Infrastructure Partners, acknowledges that it is important to pay close attention to macroeconomic conditions in individual markets, particularly if there is potential for macroeconomic disturbances to lead to regulatory change as we saw when feed-in tariffs were suddenly taken away from the Spanish solar market a decade ago.

However, she adds that not all assets will be equally exposed to any given macro shift. "We remain fluid in the way we analyse individual opportunities when it comes to deploying capital," Cole explains. "Not all sectors face the same issues in all countries."

Cole points to Igneo's investment in Italian floating LNG storage and regasification terminal, OLT FSRU Toscana, as an example. The terminal was converted from an LNG tanker anchored off the Italian coast and is connected to the Italian gas transmission network via a subsea pipeline. "This is an asset that is positioned extremely strongly given the challenges that Italy faces in transitioning away from Russian gas," she says. "You can't make generalisations about markets based on the broad macroeconomic picture."

There are steps that managers can take to brace themselves for turbulence, however. The first is to ensure that balance sheets are battle-ready. "We took the view some time ago that the benign conditions and low interest rates that we have been experiencing for so long were unlikely to continue forever," Cole says. "As a result, we find ourselves in a sensible position when it comes to leverage."

Cole also emphasises the importance

Sarah Cole

Managing director, investor relations, Igneo Infrastructure Partners

Sarah Cole is a managing director of Igneo Infrastructure Partners, based in London. She joined the firm in 2018, having previously worked at Foresight Group, Citigroup and Barclays.

Ian Harding

Managing partner, Arcus Infrastructure Partners

Ian Harding was part of the team that founded Arcus in 2009. He is responsible for overseeing the formulation and execution of investment strategies. Prior to joining Arcus, Harding worked at Babcock & Brown and Citigroup.

Athanasios Zoulovits

Partner, InfraVia Capital Partners

Athanasios Zoulovits is a partner and one of the senior investors and members of the investment committee for InfraVia Capital Partners' infrastructure strategy. He has previously worked at Access Capital Partners and Societe Generale.

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> **SARAH COLE**
> **Igneo Infrastructure Partners**

of well-nurtured stakeholder relationships. "Volatile environments such as this are where strong relationships with regulators, customers and co-investors really come into play," she says.

A thematic approach

Ian Harding, managing partner at Arcus Infrastructure Partners, meanwhile, believes that a thematic approach will go a long way towards mitigating the extremes of economic cycles. "We have lived through the GFC, European sovereign debt crises and most recently, of course, the pandemic. By investing thematically, we are not looking to cycles for performance," he says. "We also try and build a balanced portfolio of risk across geography, sector and the macro components that our assets are exposed to."

Arcus has evolved its strategy in light of its experiences in previous periods of volatility, however. "We have learned that infrastructure assets, whilst resilient, do need managing. And to manage assets effectively through macro cycles you need to hold a controlling stake," Harding says.

"You need to be at the steering wheel, with your foot on the accelerator or the brake depending on the prevailing conditions. It is all about analysing the environment you are in and trying to react to it in a proactive and dynamic manner. You need to be nimble. You need to be close to your management teams so you can shift direction if required. And to do that, you need to make sure you are taking a controlling position."

Athanasios Zoulovits, partner at InfraVia Capital Partners, agrees that a proactive stance on asset management and value creation is key. "You need to provide that daily sounding board for management teams, whilst staying disciplined and play your role as a sparring partner as opposed to managing the asset yourself," he explains.

Zoulovits adds that his firm has also weathered many storms since the dawn of the asset class. He concedes, however, that the majority of investment professionals and management teams have not previously lived through a period of sustained high inflation.

"Managing costs and having price increase conversations to reflect the context, whether it is with clients or regulators, in a period of sustained high inflation, is a new challenge for most," he says. "We entered this period of macro uncertainty around 12 months ago. Back then, central banks were hopeful that inflation would be transitory and that rates could stay low. It is now clear this is no longer the case and at InfraVia we have been preparing as much as possible for the scenario that played out."

Yet in many ways, the pandemic gave asset owners the opportunity to ready themselves for adversity, before that adversity really hit. "Managers have already stress tested the resilience of their portfolios during covid," Zoulovits says. "That focus on securing the appropriate capital structure needed to preserve long-term value, has already taken place. Private markets benefit from advanced warnings and in this case, we have had at least 12 to 18 months to get ready."

Zoulovits also believes that a hands-on, value-add approach will prove critical in the months ahead, particularly when deployed in the context of long-term secular mega trends. "In the short term, the valuation of investments which are correlated to GDP could be impacted. We have been cautious on investing in those assets since 2018 in anticipation of a peak in the GDP cycle but in the current context opportunities to buy on a risk-adjusted basis could arise," he says.

"But even if this is not the case: digitisation, energy transition, mobility and the impact of demographics on social infrastructure are all trends where a value-add strategy offers a lot of levers to pull," Zoulovits adds. "This is in marked contrast to simply backing the fixed stream of cashflows that come with heavily levered core assets. There, the focus is on slicing and dicing the capital structure, and the current environment may prove difficult to optimise further."

Cole, however, remains a firm believer in proactively managed core and core-plus infrastructure, with strong ESG credentials. "Those assets will provide long-term returns, regardless of short-term shocks," she says.

Risk appetite

Risk appetites are, of course, evolving given the extreme macroeconomic and geopolitical backdrop against which investment is taking place today. "We all have to pay attention to discount rates as that is our primary way of assessing risk," says Cole. "We always take the view that if there is a year where we don't buy, sell or refinance anything, that could be a good year. It isn't necessarily about volume. It is about being responsive to the environment you are operating in."

Indeed, holding fire may prove a wise decision, given it is not a foregone conclusion that prices will adjust in line with perceptions of risk.

"Obviously, the current macroeconomic and geopolitical environment carries a lot of uncertainties which could change the risk appetite any time," says Zoulovits. "But private markets take time to react, and we have not yet seen valuations adjust in European infrastructure in the way we have in public equities. There could be a time lag and it is likely we will see some adjustment. However, there is a lot of capital still out there and some will continue to pay high prices for assets because strategically they need to deploy capital."

Prudence is a priority, therefore. This will manifest itself in careful asset selection and, particularly, in astute analysis of market environments, which must be factored into price. "Perceptions of risk vary depending on each individual market. If you look at similar assets in Western and Eastern Europe, you will be probably looking again for a premium on risk for buying in Eastern Europe," says Zoulovits. "Europe is not homogenous and that needs to be reflected in the way we price underlying assets."

Furthermore, it is dangerous to make simplistic assumptions around country risk. After all, according to Cole, the UK is currently looking like one of the riskiest places to do business.

"You need to take a comparative view. We completed a district heating deal in Estonia a few years ago with the acquisition of Utilitas, and investors initially questioned the risk we were taking in that country, based purely on the assumption that the further east you go, the riskier investing becomes," Cole says. "In reality, Estonia is stable, has strong GDP and growth, as well as an attractive interest rate environment. The UK, on the other hand, has proven to be an economic basket case in recent months. The backdrop is very uncertain."

But, of course, once again, the situation is sector specific. "People used to think that airports and toll roads were core or super-core until the pandemic, when they were impacted worst of all," says Harding. "Some shocks hit certain assets harder than others. Smart metering businesses, for example, aren't impacted by GDP at all. Infrastructure is an increasingly broad asset class such that it is still possible to build a strong portfolio even in a stressed macro environment."

Indeed, Harding points to a recent investment Arcus has made in the UK which he believes is poised for growth. "We bought a UK business in September which leases assets to water utilities to help solve leakage issues and sewage and water treatment challenges. That is an example of looking beyond the current political and macroeconomic environment and taking a more thematic approach. Sustainability is such a hot issue, and regulatory scrutiny of water companies is high. There is going to be increased demand for this type of asset going forward and so, fundamentally, we thought this was the right time to invest irrespective of currencies, or politics, or where the macroeconomy lies."

Energy crisis

One challenge that all European markets are facing, albeit to differing degrees is the energy crisis. Unsurprisingly, energy generation is bearing the brunt of an unprecedented situation.

"Energy generation is undoubtedly the most challenged sector at the moment, whether that involves green electrons or any other type of energy,"

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> **Arcus Infrastructure Partners**

says Zoulovits. "Though massive supply is needed, we are in a situation on pricing where you end up taking a lot of risk for a potentially limited base case reward and capital loss prospect on the downside. Before the electricity market regulation changes clear out, we prefer to invest in energy transition through the decarbonisation of transportation and other derivatives, rather than taking direct exposure to the pricing mechanisms of power. That is true even if there are PPAs involved because in a situation like this, those contracts risk being renegotiated."

According to Zoulovits, a clear big winner within the energy value chain in the short-term will be LNG distributors responding to just-in-case, rather than just-in-time power needs, given the focus on energy security. Indeed, InfraVia is invested in a small-scale LNG distribution platform through a business which is providing access to reliable energy to industrials in six European nations.

"Natural gas is a virtuous source of on-demand power relative to other fossil fuel alternatives, in particular to ensure transition, and should be recognised as such in the EU Taxonomy," Zoulovits says.

"Will we invest more? At the moment, I expect limited dealflow. There is a gap in bid-ask expectations given the rush of money looking to invest in the space. To match seller expectations, you would need to believe that the current power price volatility is going to last for a very long time. Of course, you also need to price in the 'stranded asset' risk if you cannot develop a credible net zero plan for those assets during your investment period."

Meanwhile, nuclear could also be poised for a comeback outside of France where it has never gone away. Brookfield Renewable, for example, recently acquired nuclear technology business Westinghouse Electric for $4.5 billion from Brookfield Business

Partners. The industrials and services business of Brookfield Asset Management had bought Westinghouse when it was bankrupt in 2018. "It is likely that we will see others following suit given that nuclear is one of the larger scale CO2 free sources of baseload power available to us as Europeans," Zoulovits explains.

Harding adds: "It will be interesting to see what takes place at COP27 in terms of how governments react to energy security issues and whether that accelerates the onshoring of more energy production rather than reliance on interconnectivity networks and pipelines.

"My belief is that we will see increased focus on domestic energy production, which will lead to greater support for renewables and will hopefully bring with it steps to ease permitting, for example. There may also be greater attention paid to grid-scale battery storage and going forward I think there will be more focus on carbon capture as well as hydrogen, although not in the immediate term. At the moment, it simply isn't cost effective."

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InfraVia Capital Partners

For Cole, meanwhile, the current situation should end all dissension when it comes to the quest for net zero. "If today's energy crisis hasn't cleared up any remaining questions about the need to transition to renewables, then I find that slightly unnerving," she says. "I don't know what else governments need to see to make it any more obvious. If climate change has failed to convince, then surely the security of supply issues we are now experiencing must do so definitively. I don't know what else could happen to make this situation any more real this winter in Europe."

Cole also believes that the private infrastructure industry must proactively address its ownership of energy assets if it is to avoid punitive action from governments. "We have always been incredibly strong believers that infrastructure investment comes with responsibilities to all stakeholders, including the communities where assets operate, employees, customers and, of course, the environment. If you don't take those responsibilities seriously, then you undermine your social licence to operate," she says.

"Sustainable value creation is in the spotlight more than ever, given discussions around windfall taxes. As managers we need to ensure we engage with customers, regulators, local communities and national government to demonstrate the value of private ownership of these social assets. If we engage in a proactive way, we can hopefully avoid a one-size-fits-all solution."

Despite undeniable headwinds, infrastructure investors have much to be positive about, including continued liquidity. "Liquidity is crucial for enabling infrastructure assets to weather shocks, and it was that liquidity that we didn't have during the GFC," says Harding. "I don't think we are facing a lack of liquidity right now, even though we are facing the dual challenges of high inflation and high interest rates."

Zoulovits, meanwhile, says that as an equity investor he is a cautious optimist by nature. "The infrastructure asset class has promised inflation correlation and in some cases GDP decorrelation," he says. "Now is the time to demonstrate it. I believe it is in this kind of environment that our asset class can outperform but it is our job now to turn that prediction into a reality." ■